No. 83-2129

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

BARBARA R. SCHREIBER,

Petitioner,

— against —

BURLINGTON NORTHERN, INC., R-H HOLDINGS CORPORATION, THE EL PASO COMPANY, TRAVIS HUBERT PETTY, WILLIAM V. HOLIK, JR., M.R. ENGLER, JR., W.C. HENDERSON, R.S. MORRIS, M.A. EHRLICK, A.M. DERRICK, RICHARD L. McCONN, D.J. MacIVER, JR., L.M. VAREN KAMP, HOWARD BOYD, WILLARD F. ROCKWELL, JR., W.D. NOEL, L. EMORY KATZENBACH, BEN F. LOVE, KENNETH RUSH, and J.R. HUBBARD,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF FOR PETITIONER

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Respondents.

REPLY BRIEF FOR PETITIONER

I.
RESPONDENTS MISSTATE THE FACTUAL RECORD AND SEEK TO OBSCURE THE DISPOSITIVE ISSUES BEFORE THE COURT

The central issue before the Court is whether deception or nondisclosure is, in all cases, an essential element to state

a claim under Section 14(e) of the Williams Act (codified as amended at 15 U.S.C. §78n(e)(1983)). Petitioner has alleged that respondents engaged in a willful and collusive scheme in violation of the §14(e) prohibition against fraudulent or manipulative acts by causing the sale of target company stock and lock-up stock options to the offeror in exchange for the termination of a fully subscribed tender offer, submission of an inferior, revised offer and ratification of golden parachute contracts for target company management. Petitioner has argued that such deliberate misconduct committed for the sole benefit of respondents at the direct expense of target company investors

constitutes a violation of §14(e) even if disclosed.[1]

Respondents seek to evade the issues at bar through repeated misstatement of the factual record,[2] citation of authority taken out of context[3] and

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[1]Throughout this reply brief, petitioner's main brief will be referred to as "PB" and respondents' brief as "RB".

[2]Compare PB 5-12 & JA 3-16 with RB 2-5. Respondents disregard the elementary principle that on a motion to dismiss on the pleadings under F.R.C.P. 12(b)(6), the court must "...take, as true, the material facts alleged..." in the complaint. Hospital Building Co. v. Trustees of the Rex Hospital 425 U.S. 738, 740 (1976).

[3]See, e.g., RB 23 at N. 27. The portion of the sentence omitted by respondents begins "[s]heerly by weight of recent precedent, but not necessarily by force of logic,..." Junewicz, The Appropriate Limits of Section 14(e) of the Securities Exchange Act of 1934, 62 Tex. L. Rev. 1171, 1204 (1984). Respondents misrepresent the same author's position in another article cited in RB 24 at n. 29.

mischaracterization of petitioner's arguments. Despite the misleading statements of respondents, the claims raised by petitioner in the case at bar do not involve only the "wrongful termination of a tender offer" (RB 2), a "simple breach of contract" (RB 9) or a mere "breach of fiduciary duties" (RB 15). To accept respondents' view of the facts would require the Court to artificially isolate each of the transactions at issue as discrete and unrelated events without regard to the fact that each of these acts was interrelated and constituted an integral part of respondents' deliberate scheme to deprive target investors of the benefits of their free and informed choice in the tender of their shares.

Although respondents never answered the complaint, they persist in arguing a distorted view of the record based upon

supposed facts which were never part of the pleadings or considered by the courts below. Respondents state, for example, that the agreement between Burlington/R-H and El Paso management was "...beneficial to...El Paso shareholders." (RB 4), when the complaint clearly states that, it was precisely because of this agreement that target investors sustained losses and respondents profitted. See JA 15. Respondents also state that this agreement allowed "El Paso and its shareholders..." to receive "...needed equity capital." (RB 4) (emphasis added), when the fact is that this agreement served to deprive target investors of "needed equity capital" by permitting the offeror to win control of El Paso (and this "equity capital") without having to pay for the full 25.1 million shares already tendered

by El Paso shareholders. See JA 12-15.[4]

Contrary to respondents' assertion, the case at bar does involve the claims that respondents sought to "...artificially affect the market for El Paso stock" (RB 5) and competing offers were "...thwarted by the agreement"

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[4]Despite the absence of any support in the record, respondents attempt to minimize the significant and substantial damages sustained by target investors by characterizing the consideration paid in the tender offer as a "substantial premium" (RB 2, 5, 23, 41) and the price paid in the second stage of the acquisition as a "consideration equal" (RB 4, 41) to the tender offer price. In truth, the second stage offer was made for $12. net in cash plus one quarter share of Burlington preferred stock in return for each share of El Paso stock, as compared with the $24. net in cash paid for each share of El Paso stock under the terms of the tender offer. Evidence will show that the second stage offer was worth considerably less than the $24 cash offered in the first stage.

(RB 5) between Burlington/R-H and El Paso management. See PB 51, 65, 68. There is nothing in the record to support respondents' self-serving claim that El Paso management only "...bargained for the right to permit all shareholders to consider the only offer than available." RB 5. In fact, the complaint specifically alleges that El Paso management caused the termination of the fully subscribed offer "...to enable a tender of their own shares and was not for the benefit of the public shareholders of El Paso." See JA 14.

The fact that the Burlington/R-H tender offer was the "...only offer then available" is simply the direct and intended result of respondents' collusive scheme. The sale of El Paso stock and lock-up stock option to the bidder served

to deter competitive bids while ensuring that the favored bidder would gain control of the target even though the revised offer sought 4.1 million shares less than were solicited in the prior offer. See PB 65. The foregoing events constitute a continuous, interrelated and integrated chain of misconduct which cannot be isolated or distorted into a mere "breach of fiduciary duties" or "simple breach of contract" claim.

Respondents argue that the stock option agreement should be disregarded by the Court because the option was "...at the tender offer price..." and was for "...only a small portion of the target shares..." (RB 40). Respondents fail to acknowledge that this option gave the bidder effective control over 4.95 million shares of target stock without

actually having to pay the full tender offer price. Respondents also ignore the fact that it is the combination of this lock-up option and the simultaneous outright sale of 4.16 million shares of target stock that foreclosed competitive bidding for El Paso, not one or the other transaction taken alone. Cf. Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1981), cert. denied, 455 U.S. 982 (1982). (option sale of single asset, if substantial enough, may be sufficient to violate §14(e)).[5]

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[5]Respondents incorrectly claim that the Sixth Circuit recently "...retreated from Mobil..." (RB 17) in Biechele v. Cedar Point, Inc., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶91,829 (6th Cir Nov. 8, 1984). The Sixth Circuit, in

(Footnote continued on next page)

Respondents incorrectly claim that "[T]here is no factual dispute..." that the conditions contained in the December tender offer "...permitted its termination." (RB 3). In support of this claim, respondents refer the Court to the recent decision of the Delaware Court of Chancery in Gilbert & Steiner v. Burlington Northern, Inc.,[6] where the court granted summary judgment to Burlington/R-H on the state law breach of

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(Footnote continued from previous page) fact, only refused to expand the Mobil rationale to a case involving completely different facts (no lock-up option and the tender offer bid was only for fifteen percent of the target company stock.)

[6]A copy of this decision is appended to respondents' brief (RB at A1 through A13). The Delaware Court denied summary judgment, refusing to dismiss the other state law claim for conspiracy to breach fiduciary duties owed to El Paso shareholders. See RB at A 13.

contract claim. That decision is not binding on this litigation. In the first place, petitioner was not a party to that proceeding and is not bound by the result.[7] Secondly, even if it could be assumed arguendo that such conditions might be invoked in accord with state law, this does not and cannot serve to validate the misconduct at issue here under federal law, and this is particularly true where, as here, petitioner's action was commenced before the Delaware suit.

Lastly, even if this issue was to be considered solely as a matter of state

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[7]In light of respondents' ex parte stipulation to class status in the Delaware Chancery Court action, there are serious questions of collusion between the litigants to deprive the class of their federal constitutional rights of due process, notice and opportunity to be heard. Curiously, respondents do not deny collusion in the Delaware state court action.

law, respondents would be estopped from invoking these conditions to justify the termination of the December offer because the bidder waived any right it might have arguably possessed under state law to invoke these outs when it elected to proceed with the December tender offer despite continuing litigation with El Paso and others. See JA 11. Indeed, Burlington/R-H was on the verge of winning those suits and had publicized its intention to consummate the December offer. It terminated the December offer not because of the lawsuits or the occurrence of any condition, but because it had negotiated "a better deal" with respondents. By its failure to act promptly to invoke its alleged right to terminate the December offer and its deliberate conduct expressing the intent

to proceed with the offer come what may, respondents waived any breach of these conditions and forever relinquished any right to terminate the offer based upon these conditions. See Lichter v. Goss, 232 F.2d 715, 720 (7th Cir. 1956); Saverslak v. Davis-Cleaver Produce Co., 606 F.2d 208, 213 (7th Cir. 1979); 5 Williston on Contracts §691 (3d ed. 1961 & Supp. 1979).[8]

Finally, respondents argue that state law has traditionally functioned "...effectively..." (RB 34) in the context of tender offer disputes and that the one pending state court action

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[8]The estoppel issue was not briefed by the parties or passed upon by the Delaware Court since the estoppel claim was abandoned in that suit. See RB at A 13.

"...should resolve all of the substantive questions at issue." (RB 35 at n. 41).

In the first place, it is clear that no state court has, or claims to have, subject matter jurisdiction to adjudicate the federal securities laws violations at bar. Secondly, the transactions at bar have been the subject of three separate state court lawsuits filed thus far,[9] and more could be expected to be filed before the applicable statute of limitations constitutes a bar. No doubt

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[9]Respondents cite three cases involving state law claims: Gilbert & Steiner v. Burlington Northern, Inc. (copy appended to respondents' brief at A 1); Gelobter v. Petty (cited in RB 18 at n. 23); and Smachlo v. Birkelo, 576 F. Supp. 1439 (D. Del. 1983), and two cases adjudicating federal law claims: Brill v. Burlington Northern, Inc., 590 F. Supp. 893 (D. Del. 1984) and the instant case.

respondents' concern over the potential for numerous additional suits led them to make the improper ex parte stipulation to class status in Delaware Chancery Court. Clearly, it is state court adjudication which poses the greatest risk of inconsistent and constitutionally defective results because without federal control and uniform regulation of tender offer misconduct such as that at issue here, inconsistent state action will almost certainly result.

II.

RESPONDENTS MISCONSTRUE §14(e)

Respondents' central point is that deception must be an element of every cause of action brought under the Williams Act because §10(b) (codified at 15 U.S.C. 78j (b)(1983)) has the same "generic language" as §14(e) RB 31. Respondents do not attempt to account for

the obvious, actual differences in language or scope of application between these two sections, or offer any reasonable explanation sufficient for the Court to override the clear language of the statute. In the absence of any evidence to the contrary, Congress must be presumed, to have purposefully selected the terms "...fraudulent, deceptive, or manipulative " in enacting §14(e) and respondents offer no reason[10] to explain why Congress actually used this language if it really meant to require deception as

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[10]Respondents assert that the mere placement of the terms "...fraudulent, deceptive, or manipulative" in series means that deception is a required element under all three categories of misconduct. RB 30. This argument ignores the Court's teaching that a clause containing "or" is to be construed as a separate and additional requirement. See United States v. Naftalin, 441 U.S. 768, 774 (1979).

an essential element under every subdivision of §14(e).

As we have shown in our main brief, respondents' proposed construction makes no logical sense. Congress intended the Williams Act to protect the procedural fairness of the tender offer process. In drafting §14(e), Congress not only mandated full disclosure, but also specifically proscribed any fraudulent, deceptive or manipulative acts committed in connection with a tender offer. The plain language of the statute bars any act or practice which has the effect of frustrating the right of target investors to exercise an informed choice in the tender of their shares. Edgar v. MITE Corp., 457 U.S. 624, 634 (1982).

To read into the statute a requirement of deception as an essential element

of any fraudulent or manipulative act would defeat the very purpose of §14(e) by condoning fraud and manipulation in the tender offer process as long as disclosure is made. This construction would deprive target company shareholders of the free auction market for their shares that Congress intended to establish under the Williams Act, and permit target management and/or the bidder to reap ill-gotten gains with total impunity as long as the wrongdoing is disclosed. We submit that such a construction of §14(e) is contrary to the plain language of the statute and Congressional intent.

Respondents contend that the construction of the term "manipulative" under §10(b) is fully applicable to claims brought under §14(e) (RB 24), citing authorities decided under §10b be-

ginning with the seminal case of Sante Fe Industries, Inc. v. Green, 430 U.S. 462 (1977).[11] Petitioner submits that the manipulation barred by §10(b) is not the same type of manipulation prohibited by §14(e)(See PB 39). This Court has long recognized that the same term used in different sections of the securities laws may have different meanings. A merger, for example, is not a "sale" under §16(b), Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 600 (1973), though it is a "sale" under §10(b), SEC v. National Securities Inc., 393 U.S. 453, 467 (1969).

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[11]Although respondents quote much of the Court's language in Santa Fe, they fail to note the Court's statement that "...non-disclosure is usually essential to the success of a manipulative scheme" 430 U.S. at 477 (emphasis added). The facts at bar demonstrate how a manipulative scheme can succeed despite disclosure.

Logic dictates that the term "manipulative devices" under §10(b) has a different meaning than "manipulative acts" under §14(e). See SEC v. National Securities, Inc., 393 U.S. 453, 468 (1969); Note, Mobil Corp. v. Marathon Oil Co. - The Decision and Its Implications for Future Tender Offers, 7 Corp. L. Rev. 233, 238 (1984). In §10(b), Congress was concerned with the integrity of the trading process to insure that the buyer and the seller would be able to freely sell their shares in the market. In §14(e), on the other hand, Congress sought to ensure the procedural fairness of the tender offer process by mandating full disclosure and preventing the balance from being tipped in favor of either management or the bidder so that target company shareholders would be able to freely

exercise their choices. Full disclosure alone, cannot vindicate the policies of the Williams Act, since shareholders of the target company are not always free to tender their shares to another bidder especially where, as here, the manipulation thwarted competitive bids.

Respondents' arguments on the fraud issue are even less persuasive. It is clear from the cases cited in petitioner's main brief (PB 33-36), that fraud does not require deception or nondisclosure as an essential element to be actionable under §14(e) of the Williams Act. Although respondents do cite five dictionary definitions of fraud (RB 28), they do not inform the Court that the Webster's Third New International Dictionary 904 (1981) cited by them also defines fraud as including "...an act...by which one person obtains an ad-

vantage against conscience over another or which equity or public policy forbids as being prejudicial to another..."

This Court has long recognized that fraudulent conduct includes not only deception, but also conduct that involves a breach of legal or equitable duty, trust or confidence, especially where fiduciaries engage in deliberate and egregious breaches of the duty of loyalty by taking undue and unconscientious advantage of another for personal gain. See Moore v. Crawford, 130 U.S. 122, 128 (1889). This definition was approved again by the Court in SEC v. Capital Gains Bureau, 375 U.S. 180, 194 (1963). Indeed, the Court has gone so far as to state that the securities laws were designed to promote business ethics. United States v. Naftalin, 441 U.S. 768, 775 (1979).

III.
RESPONDENTS' MISCONDUCT VIOLATES §14(e)

The courts below never considered whether respondents' misconduct violated §14(e) in the absence of deception because petitioner's claims were dismissed on the pleadings and prior to discovery. See JA 21. We submit that respondent's misconduct constituted fraudulent or manipulative acts or practices in clear violation of the Williams Act, and petitioner should be given the opportunity to establish these violations of §14(e) upon a full record.

In Edgar v. MITE Corp., 457 U.S. 624 (1982), this Court concluded that Congress enacted the Williams Act "...to protect the investor not only by furnishing him with the necessary

information but also by withholding from management or the bidder any undue advantage that could frustrate the exercise of an informed choice." Id. at 634. In the case at bar, target management and the bidder joined forces in a deliberate and collusive scheme to deprive target company shareholders, such as petitioner, of their right to reap the benefits of their informed choice. Despite respondents' characterization of this collusive scheme as mere "...ordinary corporate activity..." (RB 41) it is clear that the acts committed by the respondents were deliberate, knowing and intentional violations of the procedural protections afforded to target company investors by the Williams Act. The facts at bar serve to underscore the pressing need for the Court to construe the Williams Act to

reach such deliberate misconduct, especially where, as here, target management and one bidder pool their resources to deprive target investors of any realistic choice in the tender of their shares.

IV.
SOUND POLICY CONSIDERATIONS SUPPORT THE VIEW THAT §14(e) PROHIBITS THE MISCONDUCT AT BAR

Despite respondents' best efforts to obscure the true and substantial policy considerations at stake in this case (RB 38), it is clear that there are strong policy arguments to support the application of §14(e) to the misconduct at bar. As we have already noted in our main brief, the primary purpose of the Williams Act was to provide a procedural framework to protect public shareholders of the target company, who would otherwise be at the mercy of target

management and the bidder, by ensuring that investors have the fairest possible opportunity to make their own investment decisions (PB 25).

In the case at bar, petitioner, like other similarly situated shareholders of El Paso, made her own investment decision by tendering her shares in the December offer. It was only after target company investors had actually tendered their shares and the December offer was fully subscribed that respondents entered into secret negotiations to prevent target shareholders from realizing the fruits of their informed choice. Certainly, the mere fact that the respondents disclosed this wrongdoing as a fait accompli cannot alter the reality that target investors were treated as "mere pawns" and left with no realistic alternative but to

succumb to respondents' collusive scheme, despite disclosure.

Respondents argue that petitioner's reading of §14(e) would require the federal courts to intrude deeply into established state policies of corporate regulation (RB 38). Clearly this is not the case. State corporation law is concerned primarily with the internal structure, organization and management of corporations, and, as this Court recently stated in Edgar v. MITE Corp., 457 U.S. 624, 645 (1982), "[t]ender offers...do not themselves implicate the internal affairs of the target company." In enacting the Williams Act, Congress was aware that tender offers are often made on a nationwide basis and that any effective regulation of tender offer misconduct would have to be based upon

uniform national standards.[12] Congress drafted §14(e) to expressly bar any conduct which could tip the balance to one or the other side. Thus, it prohibited any fraudulent, deceptive, or manipulative acts committed in connection with a tender offer, and respondents misconduct at bar clearly falls within the §14(e) prohibitions.

Respondents argue that federal court adjudication of tender offer misconduct would not "...provide any greater consistency" or "...prove any more efficacious..." than state court adjudication. (RB 35). Respondents conveniently ignore

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[12]The business judgment rule as applied in many jurisdictions is not an effective tool in the regulation of tender offer misconduct. See, e.g., Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir. 1981), cert. denied 454 U.S. 1092 (1981).

the elementary principle that state courts do not have the authority to adjudicate violations of §14(e), and it was Congress that specifically empowered the federal courts to bar the misconduct at issue here. Secondly, it is clearly state court adjudication of tender offer misconduct that poses the greatest risk of inconsistent and conflicting results because each state court is free to apply the laws of its own state which may or may not be consistent with the laws of another state having similar jurisdiction over the tender offer.[13]

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[13]There is also the substantial question whether any one state court has the authority to adjudicate a nationwide class action suit where the only jurisdictional basis is the mere presence of one or more of the parties within the state. This issue is currently before the Court in Phillips Petroleum v. Shutts (No. 84-233).

Moreover, the possibility that several different states may be called upon to judge the legality of the same tender offer misconduct can only promote delay and increase confusion.[14] A uniform federal standard, on the other hand, would remove this uncertainty and permit all tender offer participants to conform their conduct to a single, consistent rule.

As a final policy consideration, it must be noted that cash tender offers have become the preferred method for achieving a change in corporate control,

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[14]Compare Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir. 1981), cert. denied 454 U.S. 1092 (1981) with the recently reported state court decision in Data Probe, Inc. v. CRC Information Systems, (192 N.Y.L.J. No. 123 (1984) at page 7., col. 2) a copy of which is appended to this brief at A1 through A11). (different standards of "business judgment").

and as tender offers have become more commonplace, both the bidder and target management have employed many questionable tactics to protect their own interests. If respondents are permitted to prevail in this appeal, the Court would be sending an unmistakable signal to corporate management that misconduct in the tender offer context will be tolerated and even condoned under federal law, no matter how egregious, so long as disclosure is made to the shareholders. Such a message can only serve to encourage rather than curtail fraudulent and manipulative acts like those at issue here, which could severely undermine public confidence in the takeover process and discourage investing in corporate securities. It is clear that Congress intended

no such result, and the Williams Act could hardly perform its intended function if corporate wrongdoers like respondents are permitted to reap the rewards of their misconduct in blatant disregard of federal law.

CONCLUSION

The statutory language of §14(e), Congressional intent, logic and sound policy considerations require that the judgments of the courts below be reversed.

Respectfully submitted,

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Appendix
A-1

NEW YORK LAW JOURNAL
Friday, December 28, 1984
Reported at page 7, col 2.
Justice Wright

DATA PROBE, INC., v. CRC INFORMATION SYSTEMS Under date of June 20, 1984, an order was made granting to the defendants a temporary injunction, among other things enjoining the plaintiffs from amending the By-Laws of Datatab, or its corporate charger and further enjoining the sale of any of Datatab's material assets, preventing its merger with any other entity, its consolidation or reorganization and from entering into any contract purporting to bind Datatab for a period in excess of one year. Also restrained was the transfer of any Datatab funds to either of its co-plaintiffs, as well as the diversion of any of Datatab's business to its co-plaintiffs or affiliates. The injunctive mandate also embraced any transfer of Datatab employees and the making of any contracts between the plaintiffs.

On the 13th, 14th, 15th, 19th and 21st days of November 1984, a plenary trial of all of the conflicting issues between the parties was held. Plaintiffs sued for a declaratory judgment holding that an option granted by Datatab, Inc. to the defendant CRC Acquisition Corp. is invalid. The claim is made, among other things, that Datatab former directors improperly entered into an option agreement dated July 1, 1983. The agreement conferred upon CRC the right to purchase "any or all" of Datatab's shares at a price of $1.40 per share.

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The agreement was not a product of Datatab's shareholders, but the consequence of a directors' decision in managing the affair of a publicly owned corporation. In rather dramatic language, plaintiff counsel says that the dispute brings into focus the problem of excessive director conduct that usurps "the basic right of shareholders to control corporate destiny." Defendants, eschewing the imponderables of corporate karma and its response to la forza del destino, simply say that the crux of the differences between the parties is the validity of the option.

The directors who authorized the option no longer dictate Datatab's policies. Plaintiffs assert that the former directors were motivated by the doubtful morality of self-interest and that they granted the option as part of a plot and stratagem to protect their employment, in the event that CRC elected to exercise the option and thus take whole sale control of Datatab. In short, the blunt accusation is made that Datatab's former directors breached their fiduciary allegiance to Datatab.

Defendants, on the other hand, see the option as a routine product of business judgment, based upon reasons that would preserve Datatab, then losing money. Exercise of the option, defendants say, would allow revitalization of Datatab's sagging fortunes.

The principal thrust of the preliminary injunction was to preserve the status quo and, on the theory that the options's integrity had not then been impugned and nothing should be done to impair whatev-

er value it might have. Nothing in the settled order defining the parameters of the preliminary injunction tolled the expiration date of the option, or the time within which it had to be exercised.

Plaintiffs originally perceived federal issues in their option quarrel and they attacked its validity in the United States District Court for the Southern District of New York. The court there found that the option was invalid, basically, because the shareholders had been deprived of having placed before them a further competing tender offer and had no opportunity "to decide without management's overriding control," or to make an informed choice or, indeed, any choice. (Dataprobe Acquisition Corp. v. Datatab, Inc., 568 F. Supp. 1538, 1561-1562.)

The U.S. Court of Appeals, Second Circuit, reversed the District Court, ruling, in effect, that the dispute was essentially one for State jurisdiction and not a federal issue (722 F. 2d 1 [1983]; cert. den.).

The option agreement is dated July 1, 1983 and invested CRC with an option to purchase from Datatab, Inc. 1,211,045 shares of its authorized and unissued common stock; 85,119 shares of Datatab's treasury stock and 111,510 shares of its authorized and unissued shares of preferred stock, all at par value $1.00 per share.. After, a competing and larger offer was made by Data Probe. Later, CRC increased its offer to $1.40 per share.

Judge Abraham Sofaer's ruling that the option was invalid remained in effect until the United States Court of Appeals is-

sued its mandate to the District Court. On November 30, 1983, CRC, option in hand, sought to exercise it to the extent of 1,000 shares. Since, as of that date, the ruling of Judge Sofaer was still in effect, Datatab rejected the attempt by CRC. Data Probe, the principal plaintiff in the Federal Court action and the loser in the Court of Appeals, sought a stay of the Court of Appeals reversal mandate and a stay was granted to permit Data Probe an opportunity to petition for certiorari. In February, 1984, the United States Supreme Court denied certiorari. Thus, CRC was then in a position to exercise the option within its life-span.

For whatever reason, CRC did not seize and exercise the option. By its terms, the option expired as of July 1, 1984.

By reason of the described circumstances and quite apart from any substantive finding in this court that the option was invalid, plaintiffs argue that the option issue is moot and rendered so by the passage of time without its proper exercise.

The defendants argue that the rejection of the attempt to purchase 1,000 shares of Datatab under the option agreement was never explained to CRC. The president of CRC, Alvin Steinhart, testified that the next day after Datatab rejected the tender of the CRC check in the sum of $1,400 for the purchase of 1,000 shares, plaintiffs announced the present action to have the option declared invalid. The rejection, and the commencement of this action, Mr.

Steinhart said, persuaded him to conclude that any further tender or attempt to exercise the option would be a vain and futile act—an empty gesture not required. Mr. Steinhart further swore that had he believed the option would have been honored, he would have made his tender for approximately 1,400,000 shares. He also said that, at the time he made his tender for just 1,000 shares, he told Datatab's officers that his tender was only a first one and that he was prepared to make a further tender, should the first one be honored. Since no one from Datatab ever told him that the option would be honored, he appears to have concluded that it would not be honored.

In an effort to demonstrate that his willingness to go all the way with the option was buttressed by genuine fiscal ability, Mr. Steinhart pointed to two letters fron National Westminster Bank, dated, respectively, March 11, 1983 and June 28, 1984 (both within the option period). The March 11th letter advised that the Bank "will hold available a $2,000,000 revolving line of credit" under specified conditions. The June 28, 1984 letter noted the Bank's approval, "subject to conditions precedent," of certain credit facilities, "for the purpose of the Borrower exercising its option . . . to purchase approximately 2/3 of the capital stock of Datatab, Inc."

The March 11, 1983, "commitment" was subject to several conditions, one of which was that CRC provide "documentation satisfactory to [the Bank] and [its] coun-

sel" that a "legally valid and enforceable tender offer has been accepted by the stockholders of Datatab, Inc." The evidence revealed and produced at the trial demonstrates that that condition was never satisfied.

The June 28, 1983 letter provides that "There shall be no litigation pending or threatened with respect to the Option." It concludes with the words that "The foregoing is not and shall not be deemed a binding agreement by the Bank to make the loans pursuant to the credit facilities." There is, then, no evidentiary support for any claim that CRC was ready, willing and able to exercise the option at any time. The litigation itself appears to bulk large as a factor obstructing the availability of needed funds to exercise the option. If, in fact, CRC was unable to exercise the option because of a lack of money, any, other reasons for not having exercised it mean little.

It would seem that there is little or no reason to pursue the declaratory judgment theme of invalidity of the option, if that subject has been rendered moot by the option's expiration. The evidence fully justifies the conclusion that, since the option expired by its own terms, through the passage of time without any attempt to exercise it while it remained in effect, the validity of the option is moot.

On the other hand, it would seem to be judicial oversight to ignore the evidence produced in support of invalidity. It is clear that plaintiffs here, hedged their position and, if one theory did not carry the

day, they wished to have a fall-back position, to wit, that whether or not the option issue is moot, it was an invalid exercise of directorial power. However, in view of the elaborate and in-depth discussion provided by District Judge Sofaer, that appears not to differ in any meaningful sense from the evidence produced here, a conclusion of invalidity cannot be avoided.

It is difficult to escape the view that the former directors of Datatab had established an extremely cozy relationship with CRC. Such intimacy between a union and management is often called a "sweetheart" relationship. It appears that the former directors were anxious to lock out any other tender offer, no matter how low CRC's might be. It further appears that they had personal interests to protect and further. That their innocence is a proper target for suspicion is found in the circumstance that their own counsel warned them about the vulnerability of the option and the employment contracts they had negotiated in connection with the option agreement. Alert to the possibility of being defendants in a law suit, the directors then insisted upon indemnification agreements from CRC.

At best, all of these circumstances demonstrate that the former directors may have had grave doubts about what may loosely be described as their "business judgment." Their doubt seems well placed. Both the employment contracts and the indemnification warranties given by CRC confirm the existence of personal interests by the directors. Despite Data-

tab's fiscal ailments, CRC was a passionate and persistent wooer. Not only would CRC lend $200,000 to Datatab, but would only charge 5% interest--this, at a time when Datatab had a line of credit with the Slavenberg frim at 4% over the prime rate of interest.

The negotiated relationship between CRC and Datatab was such, that one way or another, CRC would win control of Datatab. If it purchased two-thirds of Datatab's shares, it would have control. If the shareholders rejected the $1.40 bid for merger, CRC could still exercise its option and gain control. Once CRC had control of two-thirds of Datatab's shares, it could easily propose a merger to the remaining stockholders and simply vote its shares in favor of the proposal. Sanford Adams, at the time, the president and a director of Datatab (Steinhart had been one of its founders), testified that he was concerned about the legality of the option.

The defendants were simply unable to show that the option agreement served the best interests of the corporation and its shareholders, although the circumstances here squarely cast that burden of proof upon them (cf. Pepper v. Litton, 308 U.S. 295, 306-307; sec. 713 (a)(3), N.Y. Bus. Corp. Law.) A dark shadow was cast across the conduct of the Datatab directors and their good faith. Their faith appears to have been self-directed, and marked by a zealous devotion to their private interests. The argument that the former directors could find safe haven in the business judgment rule, is without merit here.

Corporate directors owe a strict fidelity to the obligations of their office. Good faith is the key to formation of a business judgment. That judgment must be free of taint by personal gain. This is in keeping

with the fiduciary relationship directors have with their corporations (Matter of Vogel [Lewis], 25 App. Div. 2d 212, affd. 19 N.Y. 2d 589.) Thus, directors owe an undivided loyalty and are not permitted to derive a personal profit at the expense of the corporation (Schacter v. Ketek Electric Corp., 96 App. Div. 2d 1038, 1039.)

In view of the employment contracts here negotiated and the indemnification contracts, retreat behid the business judgment rule has been barred.

"The busines judgment rule does not foreclose inquiry by the courts into the disinterested independence of . . . members of the board. . . . Indeed the rule shields the deliberation and conclusions of the chosen representatives of the board only if they possess a disinterested independence and do not stand in a dual relation which prevents an unprejudiced exercise of judgment."

(Auerbach v. Bennett, 47 N.Y. 2d 619, 632.)

Clearly, here, the exercise of judgment was deeply influenced by certain tie-in arrangements that were geared to the protection of the directors's jobs, while offering them personal protection from liability, in the event of the very lawsuit they expected by reason of their conduct.

Business judgment presumes action based upn analysis of circumstances and the best interests of the corporation, i.e., its shareholders. It is only that kind of discretion that is protected.

"Discretion is not unconfined and vagrant. It is canalized within banks that keep it from overflowing."

(Panama Refining Co. v. Ryan, 293 U.S. 388, 440 [dissenting opinion, Cardozo, J.])

Plaintiff asks for counsel fees, general and punitive damages. Such awards are provided for in various sections of the Business Corporation Law in the cases of derivative stockholders actions. No section of that law appears to cover or authorize the kinds of award prayed for by plaintiffs and no evidence was offered during the trial to support such awards. The struggle here is between corporations and the principal thrust of the pleadings and the evidence was that neither side had an adequate remedy at law, that is, in terms of money damages and the equitable intervention of equity was sought.

It is now too well settled to need extensive discussion and citations, that counsel fees are an incident of litigation, absent some statutory authorization for counsel fees and expenses, or some contractual engagement. Compare Neri v. Retail Marine Corp. 30 N.Y. 2d 393. However, plaintiffs seek damages flowing from the condemned lock-up option, as well as punitive damages by reason of the blatantly improper conduct of Datatab's former directors, acting in concert with the CRC defendants. Accordingly, there must be an

assessment hearing to determine the amount of damages to which plaintiffs are entitled and whether or not the circumstances justify the imposition, as well, of punitive damages.

The temporary injunction is dissolved and vacated.

The conterclaims advanced by the defendants must be dismissed, in view of the holding here in favor of the plaintiffs, to the extent indicated. A copy of this decision is directed to be served forthwith upon the Calendar Clerk, who is orderd to place this matter at the head of the calendar for an assessment of damages. A single judgment shall be entered, with entry to abide conclusions of the assessment hearing.